The Kroger Co. Annual Report 1985

Food Stores

Drug Stores

Convenience Stores

Food Manufacturing

The Kroger Mission Statement

Our principal objective is to be a performance-proven leader in the distribution and merchandising of food, drugs and related products and services to the consumer.

- *We will serve customers, primarily through retail stores in the U.S., whenever doing so will provide a value to them and a profit opportunity for the company.*

- *We will invest in manufacturing and distribution facilities whenever this course will improve our profit potential and increase the value received by customers of company-owned or affiliated retail outlets.*

- *We will satisfy the needs of consumers as well as, or better than, the best of our competitors, and in so doing, we will grow as a company and meet the expectations of our employees and shareowners.*

- *We will encourage our employees to be active and responsible citizens in the communities in which we operate, and we will allocate resources for activities which enhance the quality of life for our customers, employees and the general public.*

Financial Highlights for 1985

	1985	1984	Change
Sales	**$17.1 billion**	$15.9 billion	7.5%
Net earnings	**$180.8 million**	$156.6 million	15.4%
Net earnings per share	**$4.09**	$3.49	+.60
Dividends paid on common stock	**$88.4 million**	$90.0 million	−1.8%
Dividends per share	**$2.00**	$2.00	
Return on average equity	**15.5%**	14.1%	
Capital expenditures	**$362.4 million**	$310.0 million	+16.9%
Real estate data			
Food stores			
Opened and acquired	**68**	46	
Remodeled	**125**	90	
Closed	**63**	156	
Total at year end	**1,367***	1,318	
Drug stores			
Opened and acquired	**331**	26	
Remodeled	**45**	11	
Closed	**33**	14	
Total at year end	**872**	618*	
Convenience stores			
Opened and acquired	**220**	99	
Closed	**20**	8	
Total at year end	**643**	443	

* 44 stores previously classified as Drug Stores are included with Food Stores.

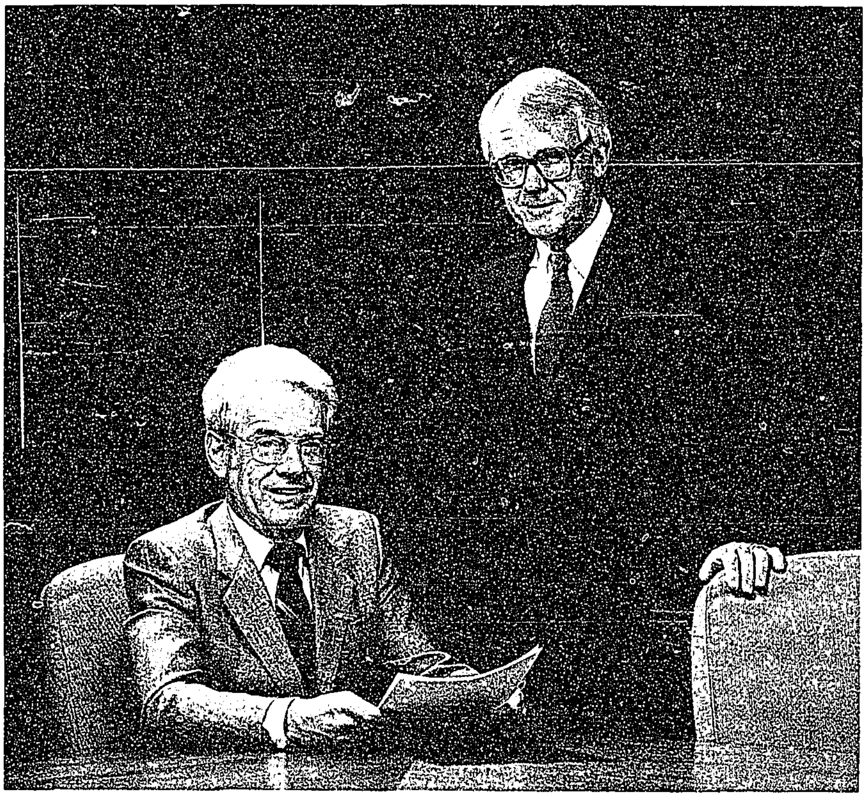
Table Of Contents

March 28, 1986

To Our Shareowners and Employees

The Kroger Co. had a successful, encouraging year in 1985.

Earnings per share, at $4.09, established a new company record, while pre-tax income rose almost 21% over 1984. Total sales reached $17.1 billion, ranking Kroger as the second largest food and drug company, and the fifth largest retailing company overall.



Lyle Everingham

William G. Kagler

The sales gain reflects real vitality in our business. Throughout 1985, inflation was virtually non-existent. Yet sales per square foot for the company's entire retail operations actually rose 3.6%.

The company further expanded its retail food operations with the acquisition of the 11 stores operated by M&M Super Markets, Inc., in the Savannah, Georgia, area. Our convenience store business also grew with the August acquisition of the 170-outlet Turkey Hill Minit Market convenience store group, plus the Turkey Hill Dairy. And in a new venture, Kroger acquired Price Savers Wholesale, Inc., Salt Lake City, operators of five 100,000 square foot membership warehouses located in the West and Alaska.

Our other primary business, drug stores, grew substantially with the addition of the 328-store Hook Drugs, Inc., acquired in mid-year. In combination with SupeRx Drug Stores, we now operate the nation's fifth largest drug chain, further strengthening Kroger's position in the important and growing drug and health care field.

With all this activity, it is useful to step back from the results of 1985 and place Kroger's performance in the context of the strategies the company is following both in the near and long term.

Our overall corporate goal, simply stated, is to become the very best food and drug retailing company.

Getting there depends upon the strategies employed to reach the goal and the abilities of the people who are asked to execute those strategies.

Kroger possesses a high level of quality in both.

The strategy the company is pursuing centers around the idea of *flexible responsiveness.*

Flexible responsiveness is a practical, realistic way to deal with changing competitive situations so typical of the food and drug retailing business. It means understanding consumer and demographic trends and then having the financial and managerial capabilities to develop profitably a retail response to those trends.

Flexible responsiveness led to the association with the Dillon Companies in 1983. Through that merger, the company balanced its asset base in retail food stores by expanding into markets which complement Kroger's traditional area of operations in the Midwest and South.

While the various Dillon divisions operate autonomously, Kroger and Dillon are pursuing a number of synergistic opportunities. Reflecting this alliance, Joseph A. Pichler, President and Chief Executive Officer of Dillon, was elected Executive Vice President of Kroger in mid-July. Mr. Pichler will retain his responsibilities at Dillon while working with senior officers of Kroger in providing overall direction to the entire corporation.

In 1985, flexible responsiveness was the strategy underlying the Price Savers acquisition. A $4

billion industry already, membership warehouse stores offer the public as well as small business operators a new kind of shopping experience. We believe the Price Savers concept shows the potential of developing a significant marketplace niche in the years ahead.

The strategy of flexible responsiveness is helping to shape the repositioning of Kroger private label food processing and procurement as a more market-oriented business.

It also is guiding Kroger's expanding position in the rapidly growing drug and health care field.

sharpen management skills and our overall "people" orientation.

This is proceeding in several areas. Numerous "task forces" have been established, bringing together managers and specialists from a variety of departments, to examine everything from communications to creativity. We believe that better informed and more involved employees will be more interested in — and, hopefully, more supportive of — Kroger's business goals.

The company also is developing programs to extend ownership of the company among its employees.

"Our overall corporate goal, simply stated, is to become the very best food and drug retailing company."

The company operates 1,379 pharmacies nationwide, including 507 in our food stores alone. Our selection and presentation of over-the-counter drug merchandise and related products also is increasing. And through Hook Drugs, the company is now expanding its successful entry in the growing home convalescent aids business.

Flexible responsiveness also led to our joint wholesaling venture in Michigan which, after only 18 months, is showing gratifying progress. To date, Foodland Distributors has realized most of its short-term objectives: besides allowing us to stay in the Michigan retail market on a profit-generating basis, the venture itself has been profitable.

Yet a strategy, no matter how well conceived, is only as good as the people who make it happen. And as an organization, Kroger is focusing increased attention on this vital component of our business.

Kroger is a decentralized operation in which independent, shared decision-making is more and more emphasized. It is thus imperative that we make every effort to

Kroger common stock is being offered to employees throughout the company, including a monthly investment plan that will get underway in 1986. Stock is given in some divisions as recognition for superior performance, and it also is offered as an alternative form of compensation in some contract negotiations.

A strategy and the people to make it work. These are the components for success in our various businesses.

The strategy — flexible responsiveness — guides our efforts to keep on top of changing competitive conditions and customer needs.

The people — the thousands of employees working in our retail stores, processing facilities and administrative offices — shape and refine the strategy, and in doing so, produce the kind of results portrayed in this annual report.

We are confident they will help make 1986 another year of growth and progress for the corporation.

Russell L. Wagner, who has served our company as a Member of the Board of Directors since 1980, is retiring effective at the May, 1986, annual meeting. His sage counsel and business acumen on the Board's Compensation, Audit and Nominating committees, and above all his friendship and guidance, will be truly missed.

Corporate Responsibility

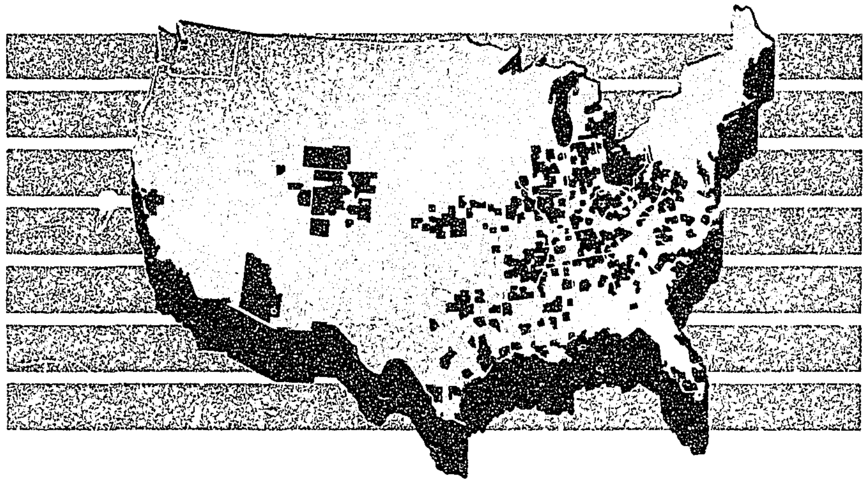
The Kroger Co. continued in 1985 its involvement in the communities in which it operates.

Alongside the personal commitment of employees, Kroger Food Stores generated $100,000 for the Second Harvest national food bank organization, and helped raise more than $50,000 for research efforts for arthritis and muscular dystrophy. SupeRx Drug Stores implemented a child identification program and produced an award-winning film on aging. Hook Drugs helped sponsor a statewide amateur athletic competition in Indiana to promote health and fitness. And Quik Stop Markets in California launched a major effort to warn customers about the dangers of drunk driving.

Kroger's 1985 contributions to non-profit causes totaled $2,369,145. In addition, the various operating units of the company made product or cash donations to support many local community undertakings. These contributions totaled $1,410,000.

Together, these activities represented a financial commitment of $3,779,145 or 1.18% of our pre-tax earnings.

Food Stores



Kroger Food Stores in the South, Midwest and Southwest
M&M Super Markets in southern Georgia
King Soopers in Colorado
Dillon Stores in Kansas Missouri and Arkansas
Fry's Food Stores in Arizona and California
City Market in Colorado, Wyoming and Utah
Gerbes Supermarkets in Missouri
Sav-Mor in Arkansas, Missouri and Oklahoma
SupeRx Food & Drug in Florida
Price Savers (membership warehouses) in Utah, Washington and Alaska

Kroger's supermarket group completed a second consecutive year of substantial progress in an especially challenging retail environment.

Total food store sales in 1985 reached $15.6 billion, a 5.5% increase over 1984. Importantly, sales in identical stores — those open at least one full year — rose 4.6%.

In many respects, the improvement is the result of sticking to the *basics* of food retailing as the best way to maintain sales and earnings growth. Throughout the food store group, renewed emphasis was placed during 1985 on customer research, market analysis, advertising and promotional programs and cost control — the real details of successful retailing.

Merchandising activity in the supermarkets increased, prompted in part by the continuing low level of food inflation.

"In many respects, the improvement in sales and earnings is the result of sticking to the basics of food retailing . . . consumer research, advertising and promotion and cost control . . . "

In such an environment, with acute downward pressure on profit margins for many products, retailers look to tonnage growth to produce year-to-year sales increases.

Food stores pursued sales with aggressive and creative merchandising programs throughout the year. Many new merchandising efforts were launched, backed by a major new commitment to advertising and in-store promotion. Kroger Food Store ad messages were more distinctive and more visible, due to a substantial increase in television placement.

Numerous "special event sales" were held during the year, in which extensive print and electronic advertising, supermarket displays and attractive pricing were combined in a focused effort to pick up the sales tempo of products over previous years.

Other promotional activities were also used. Our retail floral shops increased sales by more than 70% during an autumn "Sweetest Day" promotion, while in Kroger delicatessens, sales of fully cooked turkey dinners increased 57% over the previous year. At selected King Sooper Stores in Denver, professionally trained chefs helped customers learn the intricacies of meat and poultry preparation, while baseball legend Mickey Mantle helped launch a new hardback book section.

"In addition to efficient, productive employees and an advanced distribution network, Kroger's food stores are being upgraded to fit more precisely the needs of modern-day consumers."

Another basic part of the business, consumer research, also has been strengthened and more fully integrated into the company's merchandising efforts. Using advanced research techniques, Kroger is better able to probe consumer needs not only market by market, but in many instances, neighborhood by neighborhood.

Understanding customers in such detail has never been more essential. Supermarket competitors, particularly small local or regional operators, pride themselves on their knowledge of local consumer tastes — and they are becoming increasingly adept at responding to those tastes.

Each of Kroger's food store units is attempting to achieve that same level of intimacy in the markets it serves. Research data is used to help select the appropriate merchandising response for each market — in some cases, for specific stores within the market.

Responding to customer needs is a driving force behind the food store group's ongoing refinement of the basic supermarket facility.

Kroger's expanding drug-general merchandise selection, for example, reflects the changing nature of food store retailing. Just a few years ago, few grocery stores carried any cosmetic and fragrance products. Today it is a rapidly expanding product line in Kroger combo stores, with 1985 sales rising 15% over last year's substantial gain. Both Kroger and Dillon division supermarkets moved aggressively into videotape rentals, which has already become a $4 billion industry nationwide.

The food store group's expansion in pharmacies also is growing. Food store pharmacy sales increased approximately 27% in 1985.

Another basic of the business — maximizing the return on assets — continued to be emphasized throughout 1985.

In addition to building 43 new food stores during the year, 125 stores were remodeled, and in some instances expanded to combination store formats. Another 25 stores were added through acquisition, primarily those operated by M&M Super Markets, of Savannah, Georgia, which Kroger acquired in December.

At the same time, 63 stores, including 24 in northeastern Ohio, were closed as part of the company's ongoing asset redeployment program.

A portion of the assets freed by these store closings was used to support retail expansion. Dollars also were invested in "behind-the-scene" improvements in distribution facilities.

1986 Outlook

Competition is a fact of life in the retail food business and, in 1986, it will again be strong and varied, especially in markets with good growth potential where Kroger already has a substantial presence.

Kroger Food Stores have launched a major merchandising effort, called "Meat Excellence," to enhance customer understanding of the value and quality of Kroger meat selection.

The kinds of retailing operations the company is competing against continue to proliferate. Derivations of the super warehouse store are appearing regularly. Meanwhile, supermarkets appealing to more narrowly defined markets, such as upscale gourmet emporiums, are being brought to market by small

(continued)

and large retailers alike.

By itself, heightened competitive activity will place additional pressure on retail margins. This will be compounded if food price inflation continues at its current low levels, as most economists are forecasting.

In that setting, Kroger faces the continuing challenge of achieving and maintaining a level of parity with low cost competition.

One reason Kroger was able to intensify its merchandising efforts over the past two years was its ongoing discipline in cost control.

Administrative overhead controls initiated early in 1984 remain in effect. Meanwhile, Kroger has been able to negotiate favorable wage and benefit settlements which, in sum, represent significant cost savings.

The company's recent success in holding costs in check reflects the continuing spirit of cooperation shown by Kroger employees at all levels of the organization. They are understanding — and responding to — the changing competitive situations Kroger faces, and in doing so, have enabled Kroger's retail operations to remain strong in city after city.

Quite often, of course, cost discipline requires personal sacrifice. Recognizing that fact, Kroger food

"Kroger and Dillon food stores pursued sales with aggressive and creative merchandising programs throughout the year. Many new merchandising efforts were launched, backed by a major new commitment to advertising and in-store promotion."

Using European-style display cases Kroger bakeries add irresistable appeal to delectable store-made desserts.

In selected King Sooper Stores in Denver, professional chefs add a new value to shopping with expert advice on specialty food preparation.

"Using advanced research techniques, Kroger is better able to probe consumer needs not only market by market, but in many instances, neighborhood by neighborhood. Understanding customers in such detail has never been more essential."

store units are looking for innovative ways to share a portion of the company's improved earnings with those whose wage or benefit concessions helped support Kroger's marketplace posture. One way is through stock ownership: during 1985, approximately 40,000 shares of stock were distributed to about 3,000 employees as part of contract bargaining agreements or as performance bonuses.

Costs are also being favorably affected by improvements in Kroger's state-of-the-art procurement and distribution systems. In support of the food stores, the company operates 22 grocery product warehouses and a number of support facilities that are fully computerized for maximum distribution efficiency.

The distribution of drug and general merchandise — including items procured directly from overseas sources — has been substantially strengthened through Kroger's wholly-owned Peyton's subsidiary. Peyton's services Kroger Food Stores, SupeRx and a portion of Dillon's retail units.

In addition to efficient, productive employees and an advanced distribution network, Kroger's food store facilities are currently being upgraded and expanded to fit more precisely the needs of modern-day consumers.

As part of the food store group's growing general merchandise selection, best-selling hard-cover and paperback books are offered at discount prices

"The company's recent success in holding costs in check reflects a continuing spirit of cooperation shown by Kroger employees... They are understanding — and responding to — the changing competitive situations Kroger faces..."

Kroger is building larger stores and expanding existing units to combination store size. There are now 450 such combo stores in the company.

Because of its built-in flexibility, the combo store is being used to develop individualized merchandising and store plans oriented to specific markets.

In total for 1986, the company expects to open 55 new food stores and remodel 114 stores. The average square footage for the new stores will be about 47,300 square feet.

Drug Stores

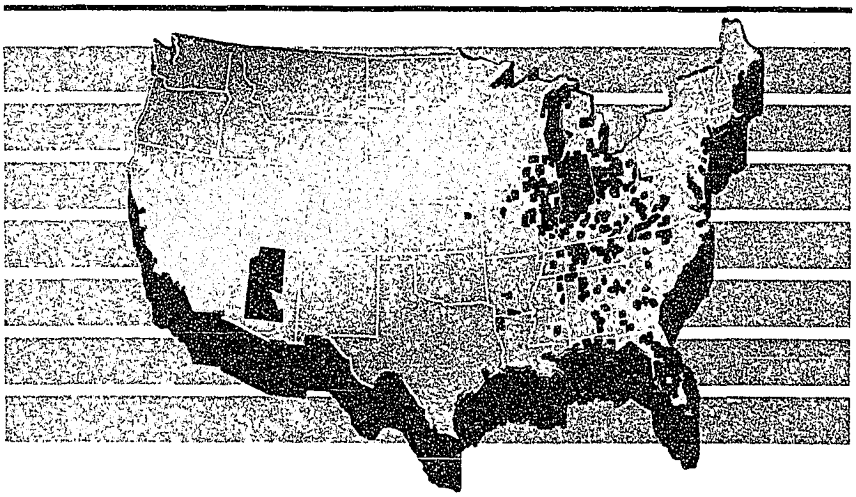
SupeRx Drug Stores in the Midwest, South, Northeast and Southwest
Hook's Drug Stores in Indiana, Ohio, Kentucky, Illinois and Michigan
Hook Convalescent Aid Centers in Indiana, Illinois, Tennessee, Kentucky and Ohio

SupeRx and Hook respond to health care needs both in retail stores (above) and in the growing home convalescent care area (facing page)

America's drug and health care business is in the midst of an unparalleled period of change.

Consumers who most buy health care products, those age 55 or older, make up a significant segment of the population, in part the result of life-prolonging breakthroughs in science and medicine. At the same time, whole new — and profitable — markets have developed in response to the millions of Americans taking better care of themselves with improved diet, active lifestyles, and a therapy of readily available over-the-counter products.

"The Hook merger added a company with a long record of success in drug and pharmacy retailing."



The way health care is provided also is changing. With hospital care costs accelerating, private corporations, governmental units and others are joining or establishing their own health maintenance organizations for employees and their families. These HMOs dispense medical treatment, once the responsibility of the private physician.

Within the health care industry itself, rising costs, increased competition and governmental deregulation have created new markets in such areas as generic drugs and mail order medication.

Amid this virtual revolution in health care, Kroger is rapidly becoming a major factor — and became even more of one in 1985 —

with its 872 retail drug stores operated by SupeRx Drug Stores and Hook Drugs, an Indianapolis-based drug and convalescent aid chain.

The drug store group achieved total sales of $1.2 billion in 1985, while operating profit totaled $44 million, reflecting the favorable impact of Hook's performance since its acquisition. SupeRx's operating profits improved for the fourth consecutive year.

The strategic approach of the drug store group consists of a balanced exposure across the entire health care market through the deployment of a wide spectrum of retail operations.

With its drug stores, the company's position in the health care retailing niche has steadily expanded. It was further extended in 1985 with the addition of Hook.

The Hook merger, completed in May, added a company with a long record of success in drug and pharmacy retailing. Hook also is well known for its extensive involvement in communities throughout Indiana and other parts of the Midwest.

Reflecting this new association, Hook Chairman and President J. Douglas Reeves was appointed in early 1986 to be Executive Vice President of SupeRx. In this expanded capacity, Mr. Reeves will have store operations responsibilities for all SupeRx and Hook retail outlets.

In addition to strengthening the company's retail drug business, the drug group is expanding its penetration into the home health care segment of the market.

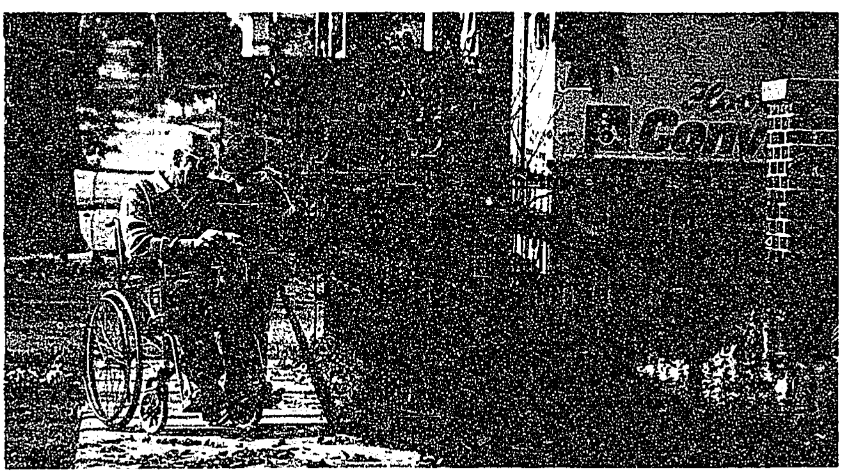
The lead in this thrust comes from Hook's 19 convalescent aid centers. These centers, four of which were added in 1985, offer an array of personal health care items, such as wheelchairs, special care beds, walking aids and monitoring equipment for patients recuperating at home.

Drug stores, meanwhile, will continue developing their nursing home business, in which maintenance prescriptions are made available to nursing home operators on a per bed basis.

SupeRx also began probing yet another facet of the health care market: "deep discount" retailing. It now operates 21 no frills outlets featuring high volume sales of drug merchandise purchased under special arrangements with suppliers.

For 1986, these complementary strategies — drug retailing and the development of the home health care market — will guide the drug store group's efforts to strengthen its overall position in the drug and health care field.

The market environment in which these strategies will be implemented contains challenges as well as opportunities. Competition is increasing not only from other drug chains, but also from new forms of health care delivery, such as privately operated health maintenance groups. Yet opportunities exist for the company to enter or expand its penetration of these new kinds of health care systems.



"The strategic approach of the drug store group consists of a balanced exposure across the entire health care market through the deployment of a wide spectrum of retail operations."

To deal with these challenges, SupeRx and Hook will continue upgrading their facilities and refining their marketing efforts.

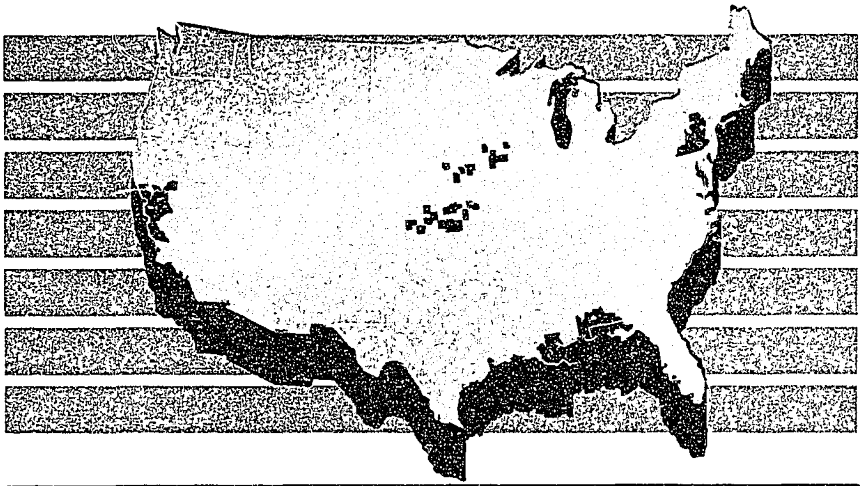
During 1986, for example, SupeRx will greatly expand its consumer research program. Additionally, SupeRx plans to continue its image promotion efforts with its "SupeRx Cares — and We Show It" campaign.

At Hook Drug Stores and convalescent aid centers, customers may charge a full line of products using the company's own "Promise Card," introduced in 1985.

SupeRx and Hook will build 41 new stores in 1986 and remodel 42 existing facilities. Many of these stores will combine a full service drug and pharmacy with features of a traditional convenience store, such as snack foods and limited grocery selection. In addition, Hook plans to add 10 convalescent aid centers.

Within the stores, pharmacy computer terminals will be installed in all SupeRx and Hook stores by the end of 1986. Besides improving customer service, the computer system also speeds inventory ordering and the collection of usage data.

The two companies also are developing synergies in pharmaceutical purchasing and private label product procurement.



"The people who use convenience stores appear to be just about everyone for whom time is short and convenience is precious. In effect, they make up a snapshot portrait of America on the move . . ."

Convenience Stores

Time Saver in Louisiana
Quik Stop Markets in northern California
Kwik Shop in Kansas, Nebraska and Iowa
Tom Thumb Food Stores in Florida and Alabama
Turkey Hill Minit Markets in Pennsylvania

A modern supermarket responds to the general needs of shoppers with a broad array of food, drugs and general merchandise. But what about customers who need a few items in a hurry, or are looking for a halftime snack?

They are the market for today's convenience store. And it is the market increasingly being served by Kroger through its Dillon convenience store group.

With 1985 sales of $404 million, Dillon's 643 "c-stores" represent a modest part of total corporate sales. Yet it is a rapidly expanding and profit-generating business that has more than doubled in size in just five years.

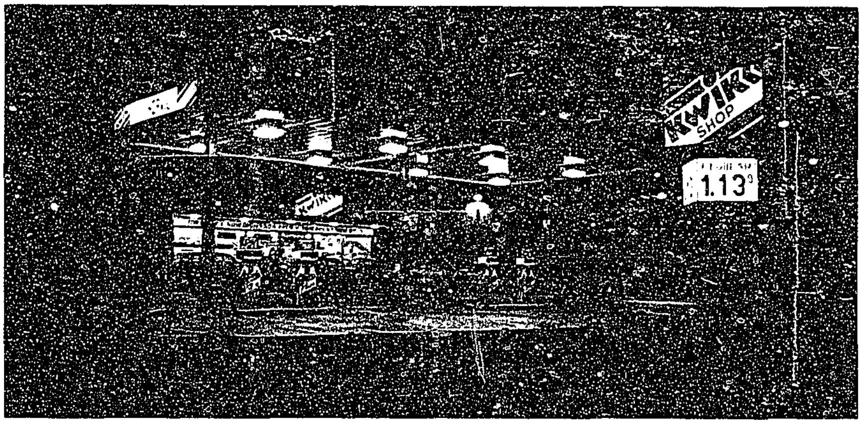
Both convenience stores and today's large supermarkets stress convenience for shoppers. Yet a typical c-store could fit easily in one corner of a modern superstore. Product selection emphasizes items, like snack foods and soft drinks, that are generally consumed within 24 hours of purchase.

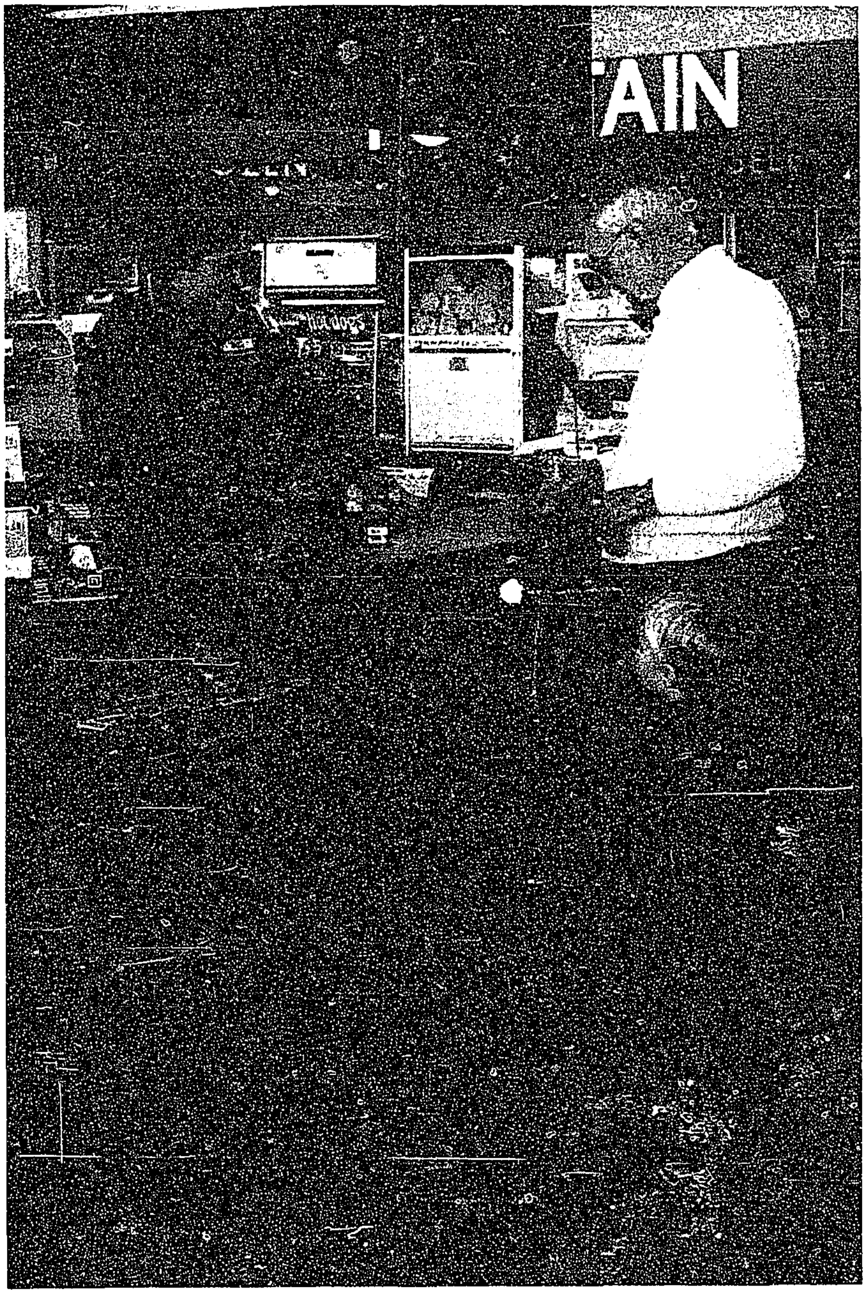
Most often, c-stores are located at high traffic intersections, and increasingly, they sell gasoline from self-service pumps outside the store.

Their competition, besides other convenience operators, are drug stores, small food markets, "drive-thru" beverage depots and — most of all — the nation's major oil companies, which are converting the corner gas station and garage to modified c-store formats.

Dillon's convenience store operations fit the normal pattern well, from the Time Saver on a busy intersection in suburban New Orleans to the new Kwik Shop serving the 1,800 residents of Greensburg, Kansas.

Dillon c-stores operate under a variety of names. Growth has been fast paced. In 1985, Farmland Industries and Turkey Hill Dairy, Inc., in eastern Pennsylvania, were added, bringing 170 outlets and a major dairy into the Dillon operation.





"Convenience stores are a rapidly expanding and profit-generating business."

Dillon convenience stores average about 2,400 square feet in size, although new stores are slightly larger. Many of the 45 c-stores scheduled for construction in 1986 will average about 2,800 square feet.

One reason for their growing size is the dynamics of convenience retailing. While the number of traditional food items for sale is decreasing, the notion of convenience shopping is being explored in everything from frozen entrees to videotape rentals. Some c-store units include seating for on-site consumption of microwave snacks.

The typical convenience store patron tends to be young, single or newly married. Yet there's no definitive customer profile: the working parent hurrying home from the day care center is a likely c-store user. So is the business executive who drops by to pick up a carton of milk and the Sunday newspaper.

In other words, the people who use convenience stores appear to be just about everyone for whom time is short and convenience is precious. In effect, they make up a snapshot of America on the move, and a significant market for this segment of Kroger's total business.

Dillon's convenience stores are ready to meet a customer's needs at any time of the day or night.

Sales of Kroger-label peanut butter, re-formulated and packaged in a new jar design, rose nearly 6%.

Food Manufacturing

Bakeries
Dairies
Grocery Products
Agri-products

Kroger Manufacturing in 1985 improved its contribution to total corporate earnings.

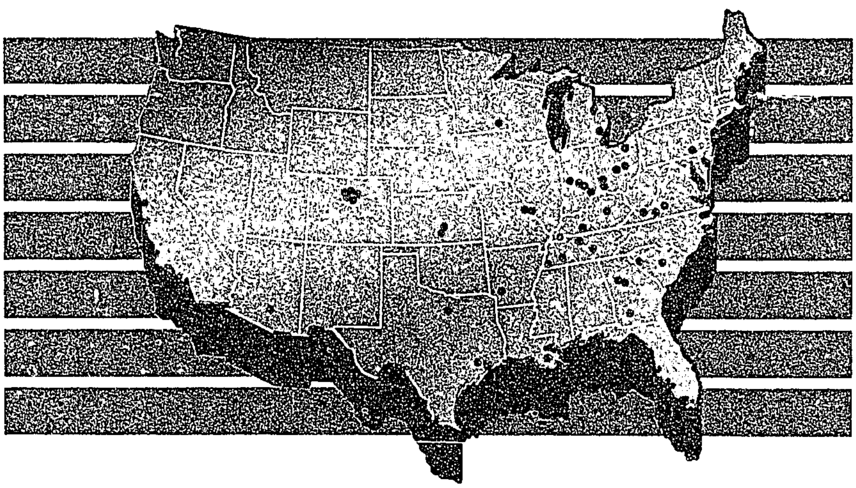
This group makes or supplies private label food products for the company's retail stores, as well as outside customers. Its sales and earnings are incorporated with those of the food stores and not reported separately.

As a major component of the company's overall business, food processing plays a significant role in Kroger's food retailing strategies. High-quality private label grocery products, along with deli items and dairy and bakery selections, complement national brands on the shelf. They also provide Kroger shoppers with especially good alternative values for their day-to-day shopping needs.

The business of private label manufacturing has undergone significant change within Kroger over the past two years.

Fueled by heightened competitive and promotional activity, national brand products have regained their market position which had declined in the late 1970's. This activity has cut into sales of private label brands. At the same time, Kroger's corporate asset redeployment program, which began in earnest in 1984, resulted in the closing of nearly 200 retail outlets for Kroger label products.

Coping with these changes has meant redirecting the focus of the



food processing business — a strategic shift which was implemented in 1984 and further extended during 1985.

The new focus has two parallel goals. On the one hand, the various components of Kroger Manufacturing are more marketing oriented. Private label products are positioned to appeal to Kroger shoppers as a high-quality value in their own right and an alternative choice to national brand products.

On the other, internal asset management is being stressed to maintain production costs at a level at least equivalent with comparable food processors.

During 1985, substantial progress was made along both these lines.

In the merchandising area, Kroger re-packaged, and in some instances re-formulated, its products to make them more competitive with national brands. Kroger peanut butter, for example, was "re-launched" in mid-year with a new jar label and formula, and sales rose nearly 6%, compared with 3.2% for national peanut butter brands. In the dairy division, Kroger's yogurt packages were upgraded, and sales reversed from a downward trend to almost a 60% increase in the last six months of the year.

The manufacturing group also continued aggressively to develop outside customers. Packing arrangements, in which Kroger manufacturing plants produce national brand products, increased significantly during the year. Additionally, work began on the development of a full line of grocery products for small and medium-sized grocery chains. Although still in an embryonic stage, sales of manufactured product under government contracts also are developing.

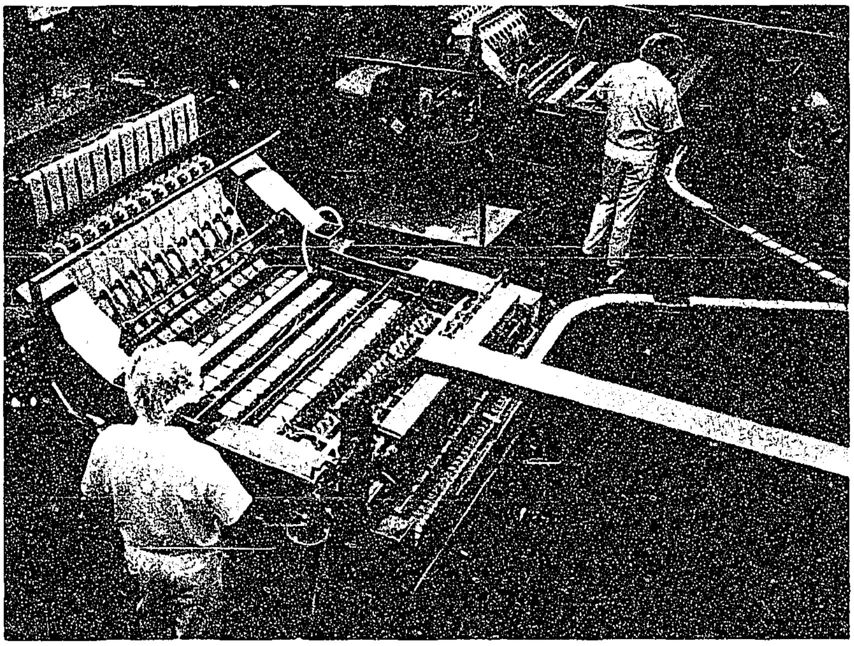
Besides expanding Kroger's food processing business, these efforts bolstered asset performance by utilizing existing plant capacity that otherwise may have been idle. Thus, the new marketing initiatives also supported the division's drive to improve total asset performance.

Several facilities not performing to expectations were disposed of during the year, including two egg production facilities and a fresh trout farm. Assets freed from these underproductive operations were redeployed for investment elsewhere, such as a new dairy in Texas to serve retail stores in the Southwest.

The processing group also strengthened and expanded its employee involvement program as part of its overall effort to improve productivity. "Quality of Work Life" programs are now in place in all Kroger manufacturing facilities.

Finally, Nutrisearch, Inc., the joint biotechnology venture between Kroger and Corning Glass Works, added a third partner in late December with the addition of Eastman Kodak Co. Renamed Nutrisearch International Corp., the venture uses a biotechnological process to produce commercial food products from dairy by-products.

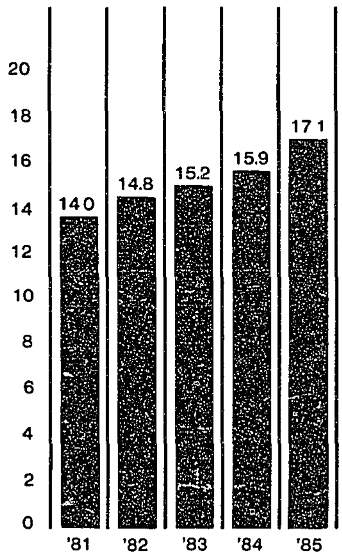
"High-quality private label grocery products, along with deli items and dairy and bakery selection, complement national brands on the shelf. They also provide Kroger shoppers with especially good alternative values for their day-to-day shopping needs."



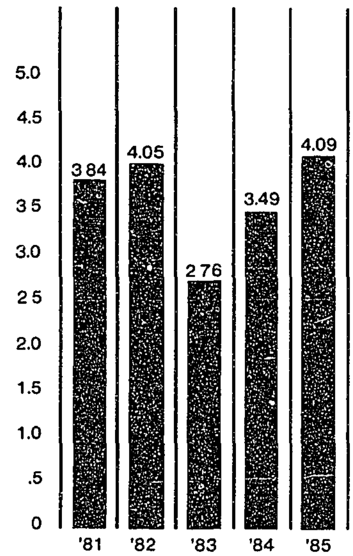
Kroger facilities produce a wide variety of products, including single slice processed cheese

"As a major component of Kroger's overall business, food manufacturing plays a significant role in Kroger's food retailing strategies."

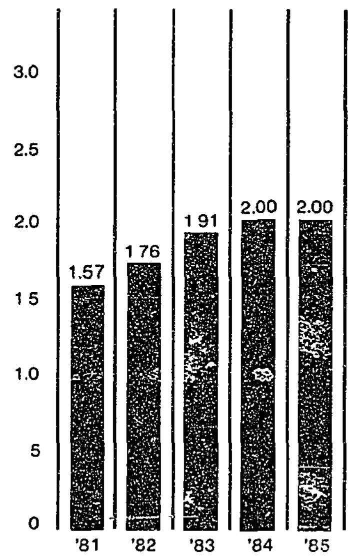
Sales (Billions)



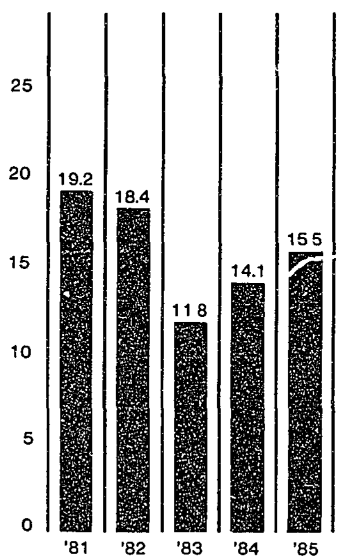
Earnings Per Share (Dollars)



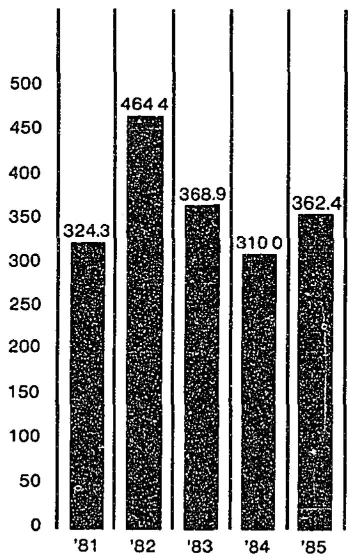
Dividends Per Share of Common Stock (Dollars)



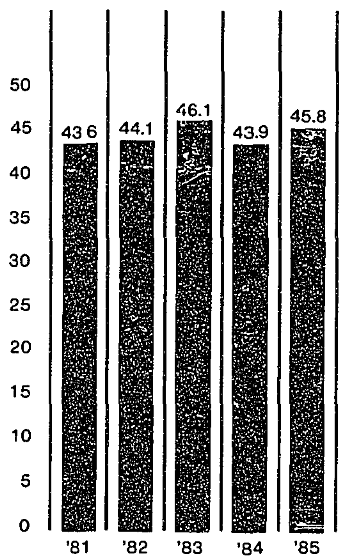
Return on Average Shareowners' Equity (Percent)



Capital Expenditures (Millions)



Food Store Square Footage (Millions)



Management's Responsibility for Financial Reporting

The consolidated financial statements of The Kroger Co. and Consolidated Subsidiary Companies and other financial information contained in this report were prepared by management, which is responsible for their integrity and completeness. These statements were prepared in conformity with generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments.

The Company has, over the years, maintained a system of internal accounting controls to provide reasonable assurance that Company assets are adequately protected, and that transactions are executed in accordance with management's authorizations and are reflected accurately in the Company's books and records as a basis for the reliable preparation of the financial statements. The system of controls includes careful selection and training of financial management personnel, clearly defined limits of authority and division of responsibility, the dissemination of detailed formal accounting and business policies and procedures, and an extensive program of internal audit examinations to monitor the effectiveness of the system. The Company has distributed to key employees its policy requiring high moral, ethical and legal standards in the conduct of its business.

Coopers & Lybrand, independent certified public accountants, have examined the consolidated financial statements in accordance with generally accepted auditing standards. Their report on the consolidated financial statements appears on this page.

The Board of Directors, acting through its Audit Committee comprised entirely of outside directors, oversees the fulfillment by management of its responsibilities in the preparation of financial statements and for financial control. The Committee recommends the selection of the Company's certified public accountants, reviews the scope and cost of the internal and external audit programs and meets formally at least twice per year with the internal and external auditors, providing them direct free access at these and other times.

Report of Independent Certified Public Accountants

To the Shareowners and Board of Directors
The Kroger Co.

We have examined the consolidated balance sheets of The Kroger Co. and Consolidated Subsidiary Companies as of December 28, 1985 and December 29, 1984, and the related consolidated statements of earnings and accumulated earnings and changes in financial position for the years ended December 28, 1985, December 29, 1984 and December 31, 1983. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the consolidated financial position of The Kroger Co. and Consolidated Subsidiary Companies as of December 28, 1985 and December 29, 1984, and the consolidated results of their operations and the changes in their financial position for the years ended December 28, 1985, December 29, 1984 and December 31, 1983, in conformity with generally accepted accounting principles applied on a consistent basis.

Coopers & Lybrand

Coopers & Lybrand
Cincinnati, Ohio
February 21, 1986

Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's discussion and analysis should be read in conjunction with the Consolidated Financial Statements and the Ten Year Summary. An estimate of the effect of inflation on the financial condition of the Company is included in Notes to Consolidated Financial Statements beginning on page 28.

Liquidity and Capital Resources
For the three years ended December 28, 1985, cash provided from operations totaled $1.1 billion. In 1985, additional cash was provided through a $110.5 million increase in short-term notes payable and a net increase in long-term debt and obligations under capital leases of $126.5 million (including $100.0 million of short-term borrowings to be refinanced). $289.3 million was generated from the Company's continuing program of redeployment of assets and from various sale-leaseback transactions. Combined funds of $1.6 billion were generated.

Of total funds generated, $1.0 billion was used for capital expenditures, $268.3 million was expended for acquisitions, $265.8 million for dividends and $148.4 million for purchase of outstanding stock. Inventories increased $422.5 million due to acquisitions, an increase in variety in larger combination food and drug stores, and the Company's program of forward buying. Food segment and drug segment square footage increased 1.7 million and 2.4 million, respectively.

Long-term obligations, as a percentage of long-term capitalization were:

	Percent of Long-Term Capitalization		
	1985	1984	1983
Senior debt	**33.6%**	30.0%	34.1%
Capitalized lease obligations	**10.2**	10.4	10.9
Total	**43.8%**	40.4%	45.0%
Pre-tax coverage of interest and rents (times)	**1.96**	1.84	1.71

1986 plans include the opening of 55 food stores, 41 drug stores and 45 convenience stores and the remodel or expansion of another 114 food stores and 42 drug stores. Capital expenditures will be approximately $350 million and will be funded primarily with internally generated cash flow. The Company will use sale-leaseback and debt financing to reduce short-term commercial paper,

which averaged $161.7 million outstanding for 1985. The Company has available a revolving credit aggregating $250 million with a group of banks against which it may obtain interim loans until March, 1989. The loans may be converted, at the Company's request, into term loans payable over six years. In addition, the Company has available $162.8 million bank annual lines of credit.

Results of Operations

Of the 7.5% increase in total sales for 1985, 2.0% was due to 1985 acquisitions. Sales for identical stores increased 4.6% in the food store segment and 5.5% in drug stores in 1985. Combined with the virtual absence of food inflation, substantial real growth was achieved in sales per square foot.

	1985 Percent of Total Sales	Sales per Average Square Foot 1985	1984	1983
			(Dollars)	
Food business	**91**	**347**	328	315
Drug stores	**7**	**148**	125	121

Gross profit increased to 23.6% of sales in 1985 from 23.5% in 1984 and 1983. In addition to the favorable effects of the Company's forward buying inventory program and improved product mix, the $23.6 million decrease in pre-tax LIFO charges from 1984 to 1985 improved the gross profit margin by .2%.

Operating, general and administrative expenses as a percent to sales declined for the third year in a row to 18.67% from 18.83% in 1984 and 19.08% in 1983, reflecting in part concessions received through collective bargaining.

Taxes based on income increased to an effective rate of 43.6%; 2.6% higher than 1984, due primarily to lower capital gains in 1985 vs. 1984.

Earnings per share increased 5¢ in 1985 from the open market purchase of common shares by the Company. The average number of shares outstanding decreased in 1985 to 44.2 million, a result of the average effect of 1.7 million shares purchased for treasury during the year. The average number of shares declined to 44.9 million in 1984 from 46.0 million in 1983, and improved 1984 earnings per share by 8¢.

Consolidated Balance Sheet

(In thousands of dollars)

	December 28, 1985	December 29, 1984
ASSETS		
Current assets		
Cash and temporary cash investments	$ 105,510	$ 163,209
Receivables	215,414	204,062
Inventories:		
FIFO cost	1,696,590	1,463,626
Less LIFO reserve	(223,834)	(217,641)
	1,472,756	1,245,985
Property held for sale	88,022	10,724
Prepaid and other current assets	119,431	116,049
Total current assets	2,001,133	1,740,029
Notes receivable	34,218	35,788
Property, plant and equipment		
Land	147,343	134,731
Buildings and land improvements	461,894	461,037
Equipment	1,685,093	1,533,050
Leaseholds and leasehold improvements	544,836	466,984
Leased property under capital leases	269,430	257,586
	3,108,596	2,853,388
Allowance for depreciation and amortization	(1,117,145)	(1,006,952)
Property, plant and equipment, net	1,991,451	1,846,436
Investments and other assets	151,005	65,073
Total Assets	$4,177,807	$3,687,326

The accompanying notes are an integral part of the consolidated financial statements.

	December 28, 1985	December 29, 1984
LIABILITIES		
Current liabilities		
Current portion of long-term debt	$ 35,730	$ 57,233
Current portion of obligations under capital leases	5,920	5,601
Notes payable	122.170	4,216
Accounts payable	986,729	902,542
Other current liabilities	487,788	424,132
Accrued income taxes	89,124	69,783
Total current liabilities	1,727,461	1,463,507
Long-term debt	710,890	577,842
Obligations under capital leases	214,586	200,815
Deferred income taxes	314,390	274,576
Employees' benefit fund	21,810	21,810
Total Liabilities	2,989,137	2,538,550
SHAREOWNERS' EQUITY		
Common capital stock, par $1, at stated value Issued: 1985 - 48,522,808 shares 1984 - 48,244,537 shares	396,387	381,696
Accumulated earnings	980,003	887,606
Common stock in treasury, at cost 1985 - 4,839,972 shares 1984 - 3,158,754 shares	(187,720)	(114,952)
Net unrealized loss on marketable equity securities		(5,574)
Total Shareowners' Equity	1,188,670	1,148,776
Total Liabilities and Shareowners' Equity	$4,177,807	$3,687,326

Consolidated Statement of Earnings and Accumulated Earnings

Years Ended December 28, 1985, December 29, 1984 and December 31, 1983
(In thousands of dollars, except per share amounts)

	1985 (52 Weeks)	1984 (52 Weeks)	1983 (52 Weeks)
Sales	**$17,123,531**	$15,922,891	$15,236,013
Costs and expenses			
Merchandise costs, including warehousing and transportation	**13,079,096**	12,175,606	11,656,585
Operating, general and administrative	**3,196,889**	2,998,366	2,907,339
Rent	**230,057**	218,857	208,394
Depreciation and amortization	**209,614**	190,664	179,660
Dividend and interest income	**(17,833)**	(23,173)	(18,231)
Interest expense	**105,145**	97,208	90,297
Total	**16,802,968**	15,657,528	15,024,044
Earnings before taxes based on income	**320,563**	265,363	211,969
Taxes based on income	**139,813**	108,730	84,890
Net Earnings	**$ 180,750**	$ 156,633	$ 127,079
Accumulated Earnings			
Beginning of year	**$ 887,606**	$ 820,944	$ 792,641
Net earnings	**180,750**	156,633	127,079
Cash dividends on common stock	**(88,353)**	(89,971)	(85,188)
Cash dividends on preferred stock			(2,250)
Reacquisition of preferred stock			(11,338)
End of year	**$ 980,003**	$ 887,606	$ 820,944
Average Shares Outstanding	**44,173**	44,933	45,970
Earnings Per Share	**$4.09**	$3.49	$2.76
Cash Dividends Per Common Share	**$2.00**	$2.00	$1.91

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Statement of Changes in Financial Position

Years Ended December 28, 1985, December 29, 1984 and December 31, 1983
(In thousands of dollars)

	1985 (52 Weeks)	1984 (52 Weeks)	1983 (52 Weeks)
Cash Provided (Used) From Operations			
Net Earnings	**$180,750**	$156,633	$127,079
Charges not involving cash:			
Depreciation and amortization	**209,614**	190,664	179,660
Provision for deferred income taxes	**39,814**	42,375	55,366
Earnings and non-cash charges	**430,178**	389,672	362,105
Other cash provided (used) net of amounts acquired:			
Increase in current cost of inventory	**(129,011)**	(124,687)	(64,851)
LIFO charge	**6,193**	29,833	22,506
Increase in other current assets	**(4,575)**	(53,564)	(45,087)
Increase in other current liabilities	**89,520**	139,489	90,466
Cash Provided From Operations	**392,305**	380,743	365,139
Cash Provided (Used) Through Financing Activities			
Cash dividends	**(88,353)**	(89,971)	(87,438)
Common stock issued	**6,146**	23,575	6,141
Capital stock reacquired	**(174,281)**	(15,194)	(61,338)
Common stock issued from treasury	**109,943**		
Increase (decrease) in notes payable	**110,512**	(1,140)	(1,815)
Additions to long-term debt and obligations under capital leases	**185,069**	36,892	178,871
Reductions of long-term debt and obligations under capital leases	**(58,590)**	(136,027)	(99,281)
Net book value of fixed asset disposals	**151,559**	78,654	59,054
Capital expenditures	**(362,436)**	(310,029)	(368,895)
Decrease (increase) in property held for sale	**(77,298)**	94,351	(34,742)
Increase in leased property under capital leases	**(11,125)**	(7,622)	(25,800)
Amounts assigned for mergers and acquisitions:			
Net current assets	**(50,190)**		
Property, plant and equipment	**(132,467)**		
Other assets	**(97,149)**		
Long-term debt, including obligations under capital leases	**20,340**		
Other changes, net	**18,316**	(33,129)	8,016
Cash Used Through Financing Activities	**(450,004)**	(359,640)	(427,227)
Increase (Decrease) in Cash and Temporary Cash Investments	**(57,699)**	21,103	(62,088)
Cash and Temporary Cash Investments			
Beginning of Year	**163,209**	142,106	204,194
End of Year	**$105,510**	$163,209	$142,106

The accompanying notes are an integral part of the consolidated financial statements.

Notes to Consolidated Financial Statements

All dollar amounts are in thousands except per share amounts.

Accounting Policies

The following is a summary of certain accounting policies followed in preparing the financial statements.

Principles of Consolidation

The consolidated financial statements include the Company and all of its subsidiaries. Partially-owned affiliated companies are included in the financial statements on the equity basis. Certain amounts have been reclassified to conform to the 1985 presentation.

Acquisitions

On May 28, 1985, Hook Drugs, Inc. (Hook) was merged into a wholly-owned subsidiary of the Company. Hook operates the largest drugstore chain in Indiana (with other drugstores in Illinois, Ohio and Kentucky), and a chain of convalescent aid and home health care centers. On August 4, 1985, the Company acquired Price Savers Wholesale, Inc., a membership warehouse chain headquartered in Salt Lake City, Utah. On August 19, 1985 Dillon Companies, Inc., a wholly-owned subsidiary of the Company, acquired Turkey Hill Dairy, Inc., Conestoga, Pennsylvania and Farmland Industries, Inc., Lancaster, Pennsylvania. Farmland Industries operates convenience stores as Turkey Hill Minit Markets. On December 16, 1985, the Company acquired M & M Super Markets, Inc., Savannah, Georgia, a regional chain of 11 supermarkets.

The combined cost of these acquisitions was $268,347 and included 2,538,679 treasury shares valued at $109,943. The majority of these shares were acquired in the open market in 1985. Net assets acquired were recorded at fair value at the dates of acquisition. Cost in excess of the fair value of net assets acquired, $89,462, is being amortized on a straight-line basis over forty years.

These acquisitions have been accounted for using the purchase method and, accordingly, consolidated results include these operations from the respective acquisition dates. Combined pro forma results of operations for 1985 and 1984 would not have been materially different from reported amounts because financing costs and amortization expense resulting from the purchase method would largely offset the additional earnings.

Inventories

Inventories are stated at the lower of cost (principally LIFO) or market. Approximately 87% of inventories for 1985 and 1984 were valued using the LIFO method.

Cost for the balance of the inventories is determined by the FIFO method of inventory valuation.

Property Held For Sale

Property held for sale represents the cost of certain land and buildings held by the Company for sale during the next year.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation and amortization, which include the amortization of assets recorded under capital leases, are computed over the estimated useful lives of individual assets, composite group lives or the initial or remaining terms of leases. Buildings and land improvements are depreciated based on lives varying from 10 to 40 years and equipment based on lives varying from three to 15 years. Leasehold improvements are amortized over their useful lives which vary from four to 25 years. Upon sale, retirement or other disposition of major capitalized assets, the cost and related accumulated depreciation are removed from the accounts with any resulting gain or loss reflected in earnings. Maintenance and repair costs are expensed in the year incurred.

Deferred Income Taxes and Investment Tax Credits

Deferred income taxes consist primarily of the amount of tax applicable to the excess of depreciation for tax purposes over depreciation used for financial reporting purposes.

Investment tax credits are included as reductions of income tax expense in the year in which the credits arise.

Other Current Liabilities

Other current liabilities as of December 28, 1985 and December 29, 1984 consists of:

	1985	1984
Salaries and wages	**$173,533**	$167,494
Taxes, other than income taxes	**99,659**	85,609
Other	**214,596**	171,029
	$487,788	$424,132

Debt Obligations

Long-term debt as of December 28, 1985 and December 29, 1984 consists of:

	1985	1984
Short-term borrowings to be refinanced	**$100,000**	
14⅜% notes maturing in 1991, redeemable at par beginning November 15, 1987	**44,825**	$ 44,825
12⅜% sinking fund debentures maturing in 2005, with annual payments of $2,500 required from 1994 through 2004	**36,950**	37,600
11% two-year extendible notes due in 1987	**45,700**	50,000
9% sinking fund debentures maturing in 1995, with annual payments of $2,500 required from 1990 through 1995	**16,570**	19,780
8.7% sinking fund debentures maturing in 1998, with annual payments of $3,000 required from 1990 through 1998	**28,499**	28,882
8½% sinking fund debentures maturing in 2001, with annual payments of $2,500 required from 1994 through 2001	**20,370**	26,917
5⅝% to 14¼% industrial revenue bonds, with annual payments due in varying amounts through 2022	**365,108**	339,626
5⅝% to 12⅞% mortgages with annual payments due in varying amounts through 2010	**60,663**	61,612
5% to 12½% notes, with annual payments due in varying amounts through 2004	**27,935**	25,833
Total debt	**746,620**	635,075
Less amount due within one year	**(35,730)**	(57,233)
Total long-term debt	**$710,890**	$577,842

The aggregate annual maturities and required payments of long-term debt for the five years subsequent to 1985 are:

1986	$35,730
1987	$70,095
1988	$22,884
1989	$23,512
1990	$23,384

Certain industrial revenue bonds and mortgage notes payable are collateralized by property, plant and equipment. Interest expense on approximately 40% of the industrial revenue bonds is determined on rates which vary with the prime or other variable rates.

Under certain of the loan agreements, payments of cash dividends are limited. Under the most limiting agreement, accumulated earnings were unrestricted in the amount of $318,000 at December 28, 1985.

The Company periodically engages in short-term borrowing. Short-term borrowing for the three years ended December 28, 1985 was:

	1985	1984	1983
Weighted average for the year	**$161,658**	$ 42,613	$ 82,859
Highest level outstanding during the year	**$383,871**	$108,942	$156,963
Weighted average interest rate	**8.08%**	10.09%	9.03%

At December 28, 1985, the Company had available a revolving credit aggregating $250,000 against which it may obtain interim loans until March, 1989. The interest rate on the interim loans would vary between The First National Bank of Chicago corporate base rate, and that rate plus ¾% per annum. The interim loans may be converted into term loans payable over six years. No amounts have been borrowed under this agreement. In addition, the Company has available $162,800 bank annual lines of credit. The interest rate on these lines is the prime rate at the respective banks.

Interest costs capitalized in 1985, 1984 and 1983 amounted to $3,831, $2,868 and $7,069, respectively.

Leases

The Company operates principally in leased premises. Lease terms generally range from 10 to 25 years with options of renewal for additional periods. Options provide in some cases for reduced rentals and/or the right to purchase. Certain of the leases provide for contingent payments based upon a percent of sales.

Rent expense (under operating leases) consists of:

	1985	1984	1983
Minimum rentals, net of minor sublease rentals	$207,597	$198,944	$190,822
Contingent payments	22,460	19,913	17,572
Total	$230,057	$218,857	$208,394

Assets recorded under capital leases consist of:

	1985	1984
Distribution and manufacturing facilities	$110,440	$114,389
Store facilities	158,990	143,197
Less accumulated amortization	(85,091)	(80,037)
	$184,339	$177,549

Minimum annual rentals, net of subleased rentals under operating leases of $430,119, for the five years subsequent to 1985 and in the aggregate are:

	Capital Leases	Operating Leases
1986	$ 31,725	$ 214,940
1987	31,643	210,348
1988	31,493	204,346
1989	31,475	201,366
1990	31,335	194,483
1991 and thereafter	382,687	1,955,628
	540,358	$2,981,111
Less estimated executory costs included in capital leases	(35,131)	
Net minimum lease payments under capital leases	505,227	
Less amount representing interest	(284,721)	
Present value of net minimum lease payments under capital leases	$220,506	

Common Stock

The Company has authorized 125,000,000 shares of $1 par common capital stock. For the three years ended December 28, 1985, changes in common stock were:

	Issued		In Treasury	
	Shares	Amount	Shares	Amount
January 1, 1983	47,134,665	$350,628	2,635,824	$ 98,749
Exercise of stock options	148,096	2,142	11,627	454
Stock issued in exchange for debt	76,630	2,792		
Tax benefit from exercise of non-qualified stock options		639		
Dividends reinvested under stock purchase plan	32,752	1,207		
December 31, 1983	47,392,143	357,408	2,647,451	99,203
Exercise of stock options	197,666	3,263	16,303	555
Stock issued in exchange for debt	607,914	18,741		
Common stock reacquired			495,000	15,194
Tax benefit from exercise of non-qualified stock options		713		
Dividends reinvested under stock purchase plan	46,814	1,571		
December 29, 1984	48,244,537	381,696	3,158,754	114,952
Exercise of stock options	245,267	4,732	18,597	905
Common stock reacquired			4,201,300	174,281
Stock issued for acquisition		7,525	(2,538,679)	(102,418)
Tax benefit from exercise of non-qualified stock options		1,020		
Dividends reinvested under stock purchase plan	33,004	1,414		
December 28, 1985	48,522,808	$396,387	4,839,972	$187,720

Preferred Stock

The Company has authorized 5,000,000 shares of voting cumulative preferred stock, 4,500,000 of which are currently available for issuance. The stock has a par value of $100 and is issuable in series. None is outstanding at December 28, 1985.

During 1983, the Company reacquired the outstanding preferred stock for $61,338. The excess of cost over par value of the shares reacquired, $11,338, was charged to accumulated earnings.

Stock Option Plans

The Company grants stock options under various plans at an option price equal to the fair market value of the stock at the date of grant. In addition to cash payments, the plans provide for the exercise of options by exchanging issued shares of stock of the Company. At December 28, 1985 and December 29, 1984, 1,736,514 and 15,763 shares of common stock, respectively, were available for future options. Options available at December 28, 1985, may be granted until 1995 and will expire 10 years from the date of grant. At December 28, 1985, options on 936,414 shares were exercisable.

Changes in options outstanding under the Stock Option Plans of the Company were:

	Shares Subject To Option	Option Price Range Per Share
Outstanding, January 1, 1983	1,219,100	$ 7.78 - $42.44
Granted	429,500	$36.06 - $42.19
Exercised	(148,096)	$ 7.78 - $36.38
Cancelled or expired	(12,150)	$19.75 - $36.38
Outstanding, December 31, 1983	1,488,354	$ 7.78 - $42.44
Granted	104,800	$30.50 - $38.13
Exercised	(197,666)	$ 7.78 - $31.38
Cancelled or expired	(55,074)	$ 7.91 - $40.44
Outstanding, December 29, 1984	**1,340,414**	**$ 8.63 - $42.44**
Granted	**528,523**	**$38.06 - $45.31**
Assumed in acquisition	**68,950**	**$16.51 - $27.12**
Exercised	**(263,827)**	**$ 8.63 - $38.81**
Cancelled or expired	**(40,096)**	**$21.25 - $38.81**
Outstanding, December 28, 1985	**1,633,964**	**$12.85 - $45.31**

In addition to stock options, the Company may grant Stock Appreciation Rights (SAR's) to certain officers. In general, the eligible optionees are permitted to surrender the related option and receive cash and shares of the Company's common stock having a value equal to the appreciation on the shares subject to the option. The appreciation of SAR's is charged to earnings based upon the market value of common stock. At December 28, 1985, rights related to options for 42,895 shares were outstanding at prices ranging from $12.85 to $42.38 per share.

Also, the Company may grant Restricted Stock Awards to eligible participants. In general, a Restricted Stock Award entitles an employee to receive a stated number of shares of common stock of the Company subject to forfeiture if the employee fails to remain in the continuous employ of the Company for a stipulated period. The holder of an award shall be entitled to the rights of a holder except that the restricted shares may not be transferred nor may the rights to vote or receive dividends. The award is charged to earnings over the period in which the employee performs services and is based upon the market value of common stock at the date of grant. At December 28, 1985, awards related to 31,000 shares were outstanding.

Taxes Based On Income

The provision for taxes based on income consists of:

	1985	1984	1983
Federal			
Current	**$ 73,479**	$ 47,455	$ 10,604
Deferred	**39,814**	42,375	55,366
	113,293	89,830	65,970
State and local	**26,520**	18,900	18,920
Total	**$139,813**	$108,730	$ 84,890

Investment and other tax credits reduced the tax provision by $24,584 in 1985, $17,386 in 1984 and $25,163 in 1983.

A reconciliation of the statutory federal rate and the effective rate is as follows:

	1985	1984	1983
Statutory rate	**46.0%**	46.0%	46.0%
State income taxes, net of federal tax benefit	**4.5**	3.8	4.8
Investment and other tax credits	**(7.7)**	(6.6)	(11.9)
Other, net	**.8**	(2.2)	1.1
Effective rate	**43.6%**	41.0%	40.0%

Deferred income taxes included in the Consolidated Statement of Earnings and Accumulated Earnings represent the tax effect of amounts expensed for tax purposes in excess of amounts used for financial reporting, and consist of:

	1985	1984	1983
Depreciation	**$39,707**	$40,282	$41,467
Other	**107**	2,093	13,899
	$39,814	$42,375	$55,366

Pension Plans

The Company has various non-contributory retirement plans for eligible employees. The Company also contributes to multi-employer plans jointly administered by management and union representatives. The total pension expense for 1985, 1984 and 1983 was $104,020, $113,098 and $118,895, respectively. The Company's policy is to fund pension expense as accrued and to amortize net past service obligations.

During 1984, several actuarial assumptions used in calculating pension expense for certain Company plans were changed. The most significant was to change the assumed annual investment rate of return from 7½% to 9%. The net effect of this change was to reduce 1984 pension expense by $6,862.

During 1985, other actuarial assumptions used in calculating pension expense for certain Company plans were changed. The most significant were to reduce the annual rate of increase in salaries from 7% to 5%, and to change the amortization periods of the various net past service obligations from 30 to 40 years to 10 to 40 years. The net effect of these changes was to reduce 1985 pension expense by $5,614.

Accumulated plan benefits and plan net assets for the Company administered plans were:

	January 1, 1985	January 1, 1984
Actuarial present value of accumulated plan benefits		
Vested	**$299,144**	$193,496
Nonvested	**17,944**	22,376
	$317,088	$215,872
Net assets available for benefits	**$354,626**	$322,040

During 1985, the actuarial assumption used in calculating the actuarial present value of accumulated plan benefits was changed to include full allowance for favorable early retirement privileges, and the weighted average assumed rate of return used for certain Company plans was decreased from 9% to 8%. These changes resulted in an increase in the actuarial present value of accumulated plan benefits of $63,486.

Information on the actuarial present value of accumulated plan benefits and net assets available for benefits relating to the multi-employer plans is not available.

Earnings Per Share

In 1985 and 1984, earnings per share is based on the weighted average number of common shares outstanding. The effect of common stock equivalents is not significant. In 1983, the earnings per share calculation includes 1.3 million shares in addition to average common shares for the dilutive effect of stock options and the Company's convertible preferred stock.

Store Closing Program

The Company maintains a store closing program as part of the Company's continuing review of underproductive assets.

In 1985, net earnings decreased $4.9 million, or 11¢ per share due to the current and estimated future cost of store closings and the disposition of properties. In 1984, net earnings decreased $12.3 million, or 27¢ per share.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for retired employees. The majority of the Company's employees may become eligible for those benefits if they reach normal retirement age while employed by the Company. The cost of retiree health care and life insurance benefits is recognized as expense as claims or premiums are paid. For 1985 and 1984, the combined cost for those benefits was $2,945 and $2,114, respectively.

Segments of Business

The Company operates primarily in three business segments. The food business segment represents the Company's manufacturing and retail food operations. The drug store segment consists of SupeRx Drug Stores and the operations of Hook Drugs, Inc. subsequent to May 28, 1985. The convenience store segment represents various regional chains operated by Dillon Companies, Inc.

Operating profits represent pre-tax profits excluding interest expense, general corporate expenses and corporate revenue not derived from the operations of the segments. Interest expense is net of unallocated corporate interest and dividend income.

	1985 (52 Weeks)	1984 (52 Weeks)	1983 (52 Weeks)
	(In millions of dollars)		
Sales			
Food business	**$ 15,563**	$ 14,753	$ 14,186
Drug stores	**1,157**	859	790
Convenience stores	**404**	311	260
Total	**$ 17,124**	$ 15,923	$ 15,236
Operating profits			
Food business	**$ 401.0**[1]	$ 334.3[1]	$ 313.7
Drug stores	**44.1**	27.4[2]	27.4
Convenience stores	**16.4**	12.8	8.9
Total	**461.5**	374.5	350.0
Unallocated expenses			
Corporate expense, net	**50.8**	32.2[3]	63.5[4]
Interest expense, net	**90.1**	76.9	74.5
Total	**140.9**	109.1	138.0
Earnings from continuing operations before taxes based on income	**320.6**	265.4	212.0
Taxes based on income	**139.8**	108.8	84.9
Earnings from continuing operations	**$ 180.8**	$ 156.6	$ 127.1

[1]1985 and 1984 include expenses of approximately $9.1 million and $24.6 million, respectively, resulting from the store closing program.

[2]The Company's SupeRx drug store division adopted the LIFO inventory method in 1984, which reduced operating profit by $5.5 million.

[3]Corporate expense for 1984 was reduced by $6.5 million as the result of the retirement of certain debentures.

[4]Corporate expense in 1983 increased $6.5 million due to expenses associated with the merger with Dillon Companies, Inc, and $8.2 million due to early retirement programs.

	1985 (52 Weeks)	1984 (52 Weeks)	1983 (52 Weeks)
	(In millions of dollars)		
Identifiable assets			
Food business	**$ 3,226.0**	$ 2,993.8	$ 2,931.3
Drug stores	**610.9**	359.8	304.8
Convenience stores	**153.9**	86.6	58.2
Other unallocated	**187.0**	247.1	235.5
Total	**$ 4,177.8**	$ 3,687.3	$ 3,529.8
Capital expenditures			
Food business	**$ 307.6**	$ 263.0	$ 329.5
Drug stores	**24.9**	13.1	27.2
Convenience stores	**25.5**	31.7	5.3
Other unallocated	**4.4**	2.2	6.9
Total	**$ 362.4**	$ 310.0	$ 368.9
Depreciation and amortization			
Food business	**$ 181.8**	$ 170.7	$ 162.6
Drug stores	**14.7**	8.4	7.9
Convenience stores	**8.5**	5.8	4.4
Other unallocated	**4.6**	5.8	4.8
Total	**$ 209.6**	$ 190.7	$ 179.7

Quarterly Data (Unaudited)

Quarterly sales, merchandise costs (including warehousing and transportation), net earnings and earnings per share for 1985 and 1984 were:

	Sales In Millions		Merchandise Costs In Millions	
Quarter	**1985**	1984	**1985**	1984
1st (12 Weeks)	**$ 3,823**	$ 3,633	**$ 2,933**	$ 2,787
2nd (12 Weeks)	**3,991**	3,796	**3,042**	2,886
3rd (16 Weeks)	**5,061**	4,623	**3,871**	3,549
4th (12 Weeks)	**4,249**	3,871	**3,233**	2,954
Total	**$17,124**	$15,923	**$13,079**	$12,176

	Net Earnings In Millions		Net Earnings Per Share	
Quarter	**1985**	1984	**1985**	1984
1st (12 Weeks)	**$ 31.5**	$ 18.8	**$ .70**	$ .42
2nd (12 Weeks)	**46.7**	43.2	**1.07**	.96
3rd (16 Weeks)	**45.0**	38.6	**1.01**	.86
4th (12 Weeks)	**57.6**	56.0	**1.31**	1.25
Total	**$180.8**	$156.6	**$4.09**	$3.49

Net earnings increased $6.6 million, or 15¢ per share in the fourth quarter, 1985 as a result of LIFO credits. Net earnings increased $2.2 million (5¢ per share) and $3.7 million (8¢ per share) in the first and third quarters of 1984, respectively, as a result of the retirement of certain debentures. Net earnings decreased $4.9 million (11¢ per share) in the fourth quarter, 1985, due to expenses related to store closings. Net earnings decreased $10.0 million (22¢ per share) in the second and $2.3 million (5¢ per share) in the fourth quarter of 1984 due to store closings.

Common Stock Price Range

	1985		1984	
Quarter	**High**	**Low**	High	Low
1st	**40⅞**	**37⅞**	37¾	29⅝
2nd	**45¼**	**39⅝**	33⅞	29⅛
3rd	**46**	**41¼**	39¼	32⅛
4th	**50**	**42⅜**	39½	36

Dividends of 50¢ per share of common stock were paid to Kroger shareowners on March 1, June 1, September 1 and December 1 in 1985 and 1984.

Supplemental Inflation Adjusted Financial Information (Unaudited)

The following information is an estimate of the effect of inflation on the Company's operations.

The current cost method attempts to reflect the changes in prices of the resources employed specifically in our operations and involves the use of assumptions, approximations and estimates. The results should not be viewed as precise measurements of the effects of inflation.

Earnings derived under this method include adjustments to depreciation and amortization expense for inflationary factors. The effects of inflation on merchandise costs have been recognized in the historical financial statements, to some extent, due to the use of the LIFO method of inventory valuation. Amounts prior to 1985 have been adjusted to average 1985 dollars by use of the CPI-U.

The restated net assets result in an indicated increase in shareowners' equity. The gain from decline in purchasing power of net amounts owed is primarily attributable to the debt which has been used to finance inventories and acquisitions. During a period of inflation, holders of monetary assets suffer an unrealized loss of general purchasing power, while holders of monetary liabilities experience an unrealized gain.

Adjusted net income is lower than reported in the primary financial statements. Taxation of earnings under present tax law reduces the amount of earnings available to support future business growth because changing prices adjustments are not deductible for income tax purposes. The effects of the higher taxation of earnings are demonstrated in the effective tax rates shown on the supplementary income statement.

Consolidated Statement of Earnings Adjusted for Changing Prices

For the Year Ended December 28, 1985 (52 weeks)
(In thousands of dollars)

	As Reported In The Primary Statements (Historical Costs)	Adjusted For Change In Specific Prices (1985 Current Costs)
Sales	$17,124,000	$17,124,000
Costs and expenses		
Merchandise costs, including warehousing and transportation	13,079,000	13,079,000
Operating, general and administrative	3,197,000	3,197,000
Rent	230,000	230,000
Depreciation and amortization	210,000	252,000
Dividend and interest income	(18,000)	(18,000)
Interest expense	105,000	105,000
Total	16,803,000	16,845,000
Earnings before taxes based on income	321,000	279,000
Taxes based on income	140,000	140,000
Net earnings	$ 181,000	$ 139,000
Effective tax rate — taxes based on income	43.6%	50.2%
Gain from decline in purchasing power of net amounts owed		$ 87,000
Increase in specific prices of property, plant and equipment and inventories		$ 66,000
Less effect of increase in general prices		143,000
Excess of increase in general prices over increase in specific prices		$ (77,000)

At December 28, 1985 specific prices of inventories totaled $1,697,000 and specific prices of property, plant and equipment, net of accumulated depreciation, totaled $2,338,000. No adjustment is made to merchandise costs, including warehousing and transportation, in the supplemental income statement due to the Company's use of the LIFO method of accounting for approximately 87% of its inventories.

Five-Year Comparison of Selected Financial Data Adjusted for Effects of Changing Prices

(In thousands of average 1985 dollars, except per share amounts)

	1985	1984	1983	1982	1981
Sales	**$17,124,000**	16,491,000	16,451,000	16,452,000	16,510,000
Current Cost Data					
Earnings from continuing operations	**$ 139,000**	125,000	81,000	151,000	134,000
Primary earnings per share from continuing operations	**$ 3.15**	2.78	1.77	3.27	2.98
Net assets at year-end	**$ 1,732,000**	1,795,000	1,863,000	1,977,000	2,124,000
Excess of increase in general prices over increase or decrease in specific prices	**$ (77,000)**	(65,000)	(72,000)	(169,000)	(118,000)
General Information					
Gain from decline in purchasing power of net amounts owed	**$ 87,000**	86,000	80,000	68,000	143,000
Dividends per share	**$ 2.00**	2.07	2.06	1.97	1.85
Market price per share at year-end	**$ 48⅛**	39⅞	39¼	43	29⅝
Average consumer price index	**322.2**	311.1	298.4	289.1	272.4

Notes To Supplementary Data On Changing Prices

Accounting Policies

The supplementary data on changing prices is based upon the historical financial information as reported in the primary financial statements adjusted for the changes in specific prices relating to property, plant and equipment and inventories.

Depreciation expense was calculated using the same methods and rates of depreciation as used in the historical financial statements.

Income tax expense has not been modified for any timing differences, allocations or adjustments that may result from applying the different methods in preparing the supplementary data.

No attempt has been made to calculate the benefit derived from additional realization of selling price increases necessitated by a higher level of cost of operations resulting from the application of current cost adjustments to the original historical cost of property, plant and equipment and inventories.

Current Cost

The current cost of inventories and merchandise costs represents the cost of purchasing the goods at year-end prices for inventory and prices in effect at date of sale for merchandise costs. Merchandise costs for 1985 have not been adjusted due to the use of the LIFO method for 87% of total inventories.

The current cost of property, plant and equipment and the related depreciation expense are estimates of what the Company's existing assets would cost at the respective balance sheet dates. The amounts for prior years have been adjusted to average 1985 dollars based on the CPI-U. Several methods, including indexation, direct pricing and application of square footage building and equipment costs based upon current merchandising and facility concepts, were used in estimating these amounts. These values represent the estimated current costs of existing assets and do not consider technological improvements and efficiencies associated with the normal replacement of productive capacity.

Ten Year Summary

	1985	1984	1983
OPERATIONS (In thousands of dollars, except per common share amounts)			
Sales	**$17,123,531**	15,922,891	15,236,013
Earnings from continuing operations before taxes based on income	**$ 320,563**	265,363	211,969
Taxes based on income	**$ 139,813**	108,730	84,890
Net earnings from continuing operations	**$ 180,750**	156,633	127,079
Per share			
Earnings from continuing operations	**$ 4.09**	3.49	2.76
Dividends on common stock	**$ 2.00**	2.00	1.91
BALANCE SHEET STATISTICS (In thousands of dollars, except per common share amounts)			
Inventories	**$ 1,472,756**	1,245,985	1,151,131
Working capital	**$ 273,672**	276,522	339,701
Property, plant and equipment, net	**$ 1,991,451**	1,846,436	1,769,339
Total assets	**$ 4,177,807**	3,687,326	3,529,813
Long-term debt	**$ 710,890**	577,842	665,386
Obligations under capital leases	**$ 214,586**	200,815	212,406
Shareowners' equity	**$ 1,188,670**	1,148,776	1,072,852
Per share	**$ 27.21**	25.48	23.98
OTHER STATISTICS (In thousands of dollars, except stock prices)			
Cash provided from operations	**$ 392,305**	380,743	365,139
Capital expenditures	**$ 362,436**	310,029	368,895
Rent	**$ 230,057**	218,857	208,394
Interest expense	**$ 105,145**	97,208	90,297
Common stock price range	**$ 37⅞-50**	29⅛-39½	33¾-42⅞
RETAIL FACILITIES (Areas in thousands of square feet)			
Stores—end of year (c)			
Food stores	**1,367**	1,318	1,428
Drug stores	**872**	618	606
Convenience stores	**643**	443	352
Total square feet—end of year			
Food stores	**45,751**	43,939	46,077
Drug stores	**8,689**	6,958	6,832
Convenience stores	**1,527**	1,057	809

(a) In 1979, the Company changed from the First-In, First-Out (FIFO) method of valuing certain of its inventories to the Last-In, First-Out (LIFO) method.

(b) 1976 and 1980 were fifty-three week years.

(c) Beginning in 1985, 44 stores previously classified as Drug Stores are included with Food Stores.

1982	1981	1980(b)	1979(a)	1978	1977	1976(b)
14,761,764	13,957,555	12,616,082	10,937,415	9,467,874	8,117,709	7,396,095
291,220	280,608	215,515	191,008	208,466	157,313	123,550
99,096	103,299	81,627	77,090	93,533	69,457	53,157
192,124	177,309	133,888	113,918	114,933	87,856	70,393
4.05	3.87	3.03	2.59	2.63	2.03	1.65
1.76	1.57	1.40	1.26	.89	.76	.69
1,108,786	951,773	900,095	896,147	796,183	703,358	628,866
368,266	405,065	246,011	271,211	320,461	311,844	313,053
1,610,693	1,339,626	1,138,287	962,018	814,377	728,186	685,704
3,319,699	2,964,017	2,483,504	2,232,134	2,023,767	1,843,236	1,711,128
604,007	477,501	311,036	269,026	239,172	247,060	274,310
194,195	187,516	173,268	169,561	165,856	153,958	147,883
1,086,345	1,000,049	835,066	762,194	692,894	611,169	550,937
23.29	21.33	18.84	17.26	15.82	14.12	12.88
299,232	423,566	362,986	174,008	217,170	176,947	141,100
464,380	324,280	298,766	242,324	168,543	127,944	107,757
192,114	163,779	147,877	127,269	112,138	98,455	90,237
69,819	55,583	44,662	36,849	35,920	36,912	33,425
23⅜-47¼	19¼-27⅞	14-23¾	17½-27	12¾-18½	11⅝-14⅜	8⅞-12⅝
1,418	1,475	1,459	1,438	1,406	1,384	1,362
563	507	514	504	487	528	558
352	349	333	326	290	189	186
44,088	43,615	40,846	38,341	36,113	33,729	31,556
6,261	5,715	5,841	5,657	5,591	6,108	6,399
807	800	732	718	638	400	372

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Chairman of the Board,
Dillon Companies, Inc.

Richard W. Dillon
Vice Chairman of the Board,
Dillon Companies, Inc.

Walter R. Dryden
Group Vice President

Donald F. Dufek
Group Vice President

Lyle Everingham
Chairman of the Board and
Chief Executive Officer

Jack G. Hudson
Vice President and Controller

George L. Irwin
Group Vice President

Arthur Juergens
Group Vice President

William G. Kagler
President

Lorrence T. Kellar
Vice President

Richard M. Koster
Senior Vice President

George A. Leonard
Vice President and General Counsel

Joseph A. Pichler
Executive Vice President;
President and
Chief Executive Officer,
Dillon Companies, Inc.

William J. Sinkula
Group Vice President and Secretary

John L. Strubbe
Senior Vice President

Lawrence M. Turner
Treasurer

Gerald L. Wolken
Vice President;
President, SupeRx Drug Stores

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former Chairman of the Board
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and The Seagram Company Ltd.

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Chairman of the Board and President
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Chairman of the Board
Dillon Companies, Inc.

Richard W. Dillon[7]
Vice Chairman of the Board
Dillon Companies, Inc.

Lyle Everingham[4,6]
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Chief Executive Officer
The Kroger Co.

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Of Counsel
Lewis, White & Clay

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Retired former Chairman of the Board
and Chief Executive Officer
NLT Corporation

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[1]Audit
[2]Compensation
[3]Corporate Responsibility
[4]Executive
[5]Financial Policy
[6]Nominating
[7]Pension Plans

Form 10-K
A copy of the Company's 1985 report to the Securities and Exchange Commission, Form 10-K, is available to shareowners on request by writing: Lawrence M. Turner, Treasurer, The Kroger Co., 1014 Vine Street, Cincinnati, Ohio 45201.

Annual Meeting
The annual meeting of shareowners will be held at Music Hall, 1243 Elm Street, Cincinnati, Ohio, on May 16, 1986, at 10 a.m.

Transfer Agent and Registrar
The First National Bank of Cincinnati
First National Bank Center
Fifth and Walnut Streets
Cincinnati, Ohio 45201
Telephone: In Cincinnati, call 632-4450; in other parts of Ohio, call 1-800-346-7500; other areas, call 1-800-354-0400

Independent Certified Public Accountants
Coopers & Lybrand
1500 Atrium One
201 East Fourth Street
Cincinnati, Ohio 45202

Shareowners
At the end of 1985, a total of 52,026 shareowners of record owned 43,682,836 shares of The Kroger Co. common stock.

Common Stock
The main trading market for The Kroger Co.'s common stock is the New York Stock Exchange, where it is listed under the symbol KR.

Shareowner Inquiries
If shareowners have any questions regarding their Kroger stock account or if there are any problems such as missing dividend checks or changes of address, please direct inquiries to:

The First National Bank of Cincinnati
Stock Transfer Department
First National Bank Center
Fifth and Walnut Streets
Cincinnati, Ohio 45201
Telephone: See numbers for Transfer Agent, at left.

Dividend Reinvestment and Optional Cash Purchase Plan
The Dividend Reinvestment Plan permits shareowners to reinvest their dividends in Kroger common stock without service charges or brokerage fees. In addition, participants under the Voluntary Contribution provision may make cash purchases of additional Kroger common stock on the same cost-free basis. For full details and enrollment information about the Plan, please write to the Transfer Agent, at the address shown in the first column.

Design Three Inc
Typesetting Paula Penn Kroger Corporate Advertising
Printing William Feather / Printers

The Kroger Co. 1014 Vine Street Cincinnati, Ohio 45201 (513) 762-4000